TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Annual Review of the Benchmark Modification Policy — ITEM NUMBER: 10

ATTACHMENTS: 2

ACTION: X — DATE OF MEETING: October 2, 2002

INFORMATION: ___ — PRESENTERS: Christopher Ailman

Executive Summary:

This report serves as the required annual review to the Benchmark Modification Policy. Included in the report is an annual, and two-year performance charts of the modified benchmarks. As required by the policy, CalSTRS investment staff, and the Board Consultant, PCA, reviewed the various industries under consideration for exclusion. The staff and consultant concluded that the tobacco industry was the only industry to meet three of the four standards. Therefore, staff and the consultant recommend that the CalSTRS investment benchmarks continue to exclude the tobacco industry in its portfolio.

Background:

In June 2000, the CalSTRS Investment Committee approved the attached Benchmark Modification Policy (Attachment 1). This policy is intended to modify the Fund's benchmarks when it is in the economic interest of the System. The policy, in effect, creates a series of "enhanced benchmarks" which should generate better long-term risk adjusted returns compared to the standard benchmark. The policy seeks to eliminate industries and/or sectors that face significant judicial, regulatory, and institutional investor pressure. These industries and/or sectors are also most likely to result in lower corporate earnings and potential industry wide bankruptcy.

The policy requires regular reviews of the benchmark modifications. The Committee has structured annual reviews after each fiscal year end. The annual report reviews any potential additions or deletions to the exclusion list, and reviews the performance of the current custom benchmarks.

The intent of the policy is to eliminate industries that have a high level of perceived risk. The key to successfully implementing the policy is eliminating these industries before Wall Street has fully priced, or fully estimated, the potential risk. Typical of human behavior, Wall Street frequently overestimates the potential risk and subsequently oversells the stock to a depressed level. As the facts are revealed, the "Street" either increases the risk discount, or as in this case, perceives that the risk is not as draconian as once believed and hence the share prices rebound. Often there is an overreaction in the other direction as the risk is then underestimated.

Discussion:

Performance review of the modified benchmarks.

As staff has highlighted in the past, any review of the performance is highly time period dependent. This report on the performance of the modified benchmark still only covers a relatively short period of two years. This is also a time period that exhibited tremendous volatility and turnover for the global equity markets. Due to a number of factors, staff believes that the limited data fails to support any meaningful, long-term, conclusions about the success of the benchmark modification.

For the Fiscal Year ending June 30, 2002

Asset Class	Benchmark	Benchmark return	Modified Benchmark Return	Difference (in Basis Points)
U.S. Equity	S&P 500	-17.99	-18.09	-10
	Russell SSC	-14.93	-14.98	-5
	Blended Index	-17.90	-17.99	-9
Non-US Equity	MSCI ACWI	-8.17	-8.37	-20
	MSCI EAFE	-9.50	-9.73	-23
Fixed Income	Solomon LPF	8.78	8.78	0

Since Inception of the Policy (June 30, 2001) Annualized 2 year return

Asset Class	Benchmark	Benchmark return	Modified Benchmark Return	Difference (in Basis Points)
U.S. Equity	S&P 500	-16.42	-16.76	-34
	Russell SSC	-16.24	-16.39	-15
	Blended Index	-16.40	-16.70	-30
Non-US Equity	MSCI ACWI	-16.35	-16.66	-31
	MSCI EAFE	-16.85	-16.96	-11
Fixed Income	Solomon LPF	10.29	10.29	0

The benchmark for real estate, National Council of Real Estate Investment Funds (NCREIF), does not contain tobacco; therefore, it is not modified. The benchmark for alternative investments; however, is a custom blended benchmark, while it contains some public index components, the net benchmark does not reflect a different return under the policy.

Review of the Policy for additions or deletions.

The Policy lists four criteria for consideration. If any two are met, then further due diligence is required to identify the potential risk, return, and cost effects. These factors include:

(1) The industry, not an individual company, shares common exposure to product liability judgments (including, but not limited to, potential judgments involving overwhelming punitive damage awards), settlements, and ongoing litigation that have the potential to exceed the industry's net worth.

(2) Significant threat of industry-wide bankruptcy filings.

(3) Regulatory and/or legislative actions that have the potential to substantially impair industry-wide earnings.

(4) Policy actions in the institutional investor community that, in aggregate, have the potential to have a deleterious effect on industry-wide share prices.

When any three of the above factors are present, staff, or a member of the Investment Committee, may request that the Committee commence a further review. While a review can be requested at anytime, minimally the policy should be reviewed at least once a year. The annual review takes place in the fall with a look back to the prior fiscal year end. Staff reviewed a number of industries that seem to exhibit higher levels of risk, and are discussed by other institutional investors. These included the industries of tobacco, airlines, asbestos, and entertainment (violent music).

In the June 2000 review, the tobacco industry clearly registered under three of the four factors. Since that analysis, several key events have affected the industry. In the June 2001 review, staff recommended a more in depth analysis of the issues. At the September 2001 meeting, the investment Committee tabled the matter to the fall of 2002. Now the issues under section 1, 3, and 4 have fallen from the media spot light. However, it is clear to staff, and the Board's consultant that these issues continue to remain viable threats to the industry. As a result, both staff and PCA feel that the tobacco industry meets the criteria under section 1, 3, and 4, and therefore, should continue to be excluded from the CalSTRS investment benchmarks.

Recommendation:

Based upon the CalSTRS Benchmark Modification Policy, the Chief Investment Officer and Pension Consulting Alliance continue to recommend that the Board exclude the tobacco industry from the benchmarks.

Prepared on September 10, 2002 and recommended by:

Christopher J. Ailman
Chief Investment Officer

Attachment 1
Investment Committee - Item 10
October 2, 2002

The purpose of a benchmark, as identified in the Investment Management Plan, is "To facilitate the periodic reporting to the Investment Committee and to provide a relative measure to gauge success, custom performance benchmarks are approved by the Board."

BENCHMARK POLICY

1. The Investment Committee approved performance benchmarks are used in the asset allocation process for modeling purposes. The approved benchmarks are contained in the Investment Management Plan.

2. There are four characteristics identified as desirable in the selection of an appropriate benchmark.

   (A) Unambiguous -- The names and weights of the securities in the benchmark should be clearly defined.

   (B) Investable -- The securities contained in the benchmark should represent tradable positions. Ideally, the benchmark should be constructed with low turnover (companies should not change too much over time) to minimize transactions costs.

   (C) Measurable -- The pricing of the benchmark should be transparent making it possible to track the benchmark's performance. The benchmark will, whenever practical, be calculated independently and available to the public on a daily basis (applies to publicly traded asset classes only). Appropriate -- As part of the investment planning/policy process the Investment Committee will adopt an asset class benchmark (reference portfolio) that reflects the broad risk and return characteristics of that asset class. The benchmark will be the reference portfolio against which the aggregate active and passive portfolios within that asset class will be measured.

3. As a matter of practice the approved benchmark will be reviewed by the Investment Committee on an annual basis to assure that it continues to reflect the risk/return characteristics of the asset class in a cost-effective manner. Strategic asset allocation assumptions will be based upon expected risk, return, and correlation coefficients of the approved benchmark.

BENCHMARK MODIFICATION POLICY

1. Asset class benchmarks may be modified when it is in the economic interest of the System.

2. Benchmark modification indicators are identified as:

   A. When a more cost efficient (expenses such as trading costs or transaction fees) alternative is available that captures the risk return characteristics of the asset class.

   B. When an industry or sector (component) of the benchmark is exposed to economic risks that are of such a degree that the future economic viability of that industry or sector is in doubt. Specific indicators are:

      (1) The industry, not an individual company, shares common exposure to product liability judgements (including, but not limited to, potential judgements involving overwhelming punitive damage awards), settlements, and ongoing litigation that have the potential to exceed the industry's net worth.

      (2) Significant threat of industry-wide bankruptcy filings.

      (3) Regulatory and/or legislative actions that have the potential to substantially impair industry-wide earnings.

      (4) Policy actions in the institutional investor community that, in aggregate, have the potential to have a deleterious effect on industry-wide share prices.

   C. In the event that 2A or at least three of the indicators referenced in 2B are evidenced the staff or a member of the Investment Committee may bring the matter before the Investment Committee for due diligence and consideration. This due diligence will include:

      (1) Analysis by the staff and/or third-party experts that the indicators are evidenced and have the potential to adversely impact the specific industry.

      (2) Identification and listing of the individual companies in the specific industry based upon the definition adopted by the Investment Committee.

      (3) Analysis of the impact the benchmark modification is expected to have upon total portfolio risk/return characteristics.

      (4) Analysis of the expected costs associated with implementation of the benchmark modification.

      (5) A timetable for review of the benchmark modification.

PROPOSED
RESOLUTION OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Annual Review of the Benchmark Modification Policy

Resolution No. _____________

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommendations to the Board, investment policy and overall investment strategy for the management of the Teachers' Retirement Fund, a multi-billion dollar public pension plan, and;

WHEREAS, the Investment Committee adopted the Benchmark Modification Policy on June 7, 2000, and

WHEREAS, the Investment Committee has requested an annual review of the policy and its impact as of fiscal year end each year; and

WHEREAS, the investment staff has completed the review and submitted an annual report on the Policy, potential industries to add or delete, and the results of the policies impact during the fiscal year ended June 30, 2002; Therefore, be it

RESOLVED; that the Investment Committee officially receives and files the annual Benchmark Modification report, and directs staff to continue to exclude the tobacco industry from all CalSTRS public security benchmarks.

Adopted by:
Investment Committee
on October 2, 2002

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Jack Ehnes
Chief Executive Officer